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Application of Partnership Audit Rules to Private Funds

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On November 2, 2015, President Obama signed into law the Bipartisan Budget Act of 2015, which included a new federal audit regime for partnerships and entities classified as partnerships for federal income tax purposes (the New Rules). Under the New Rules, which are effective for audits of partnership tax years beginning on or after January 1, 2018, the IRS is permitted to impose an underpayment determined under these rules (an Imputed Underpayment) directly against the partnership. This is a dramatic departure from the prior rules, known as the TEFRA rules, which required the IRS to allocate any partnership audit adjustments among the partners in the year subject to audit, and assess and collect any underpayment of tax at the partner level. The New Rules have had, and will continue to have, far-reaching implications for private funds.

Calculating and Modifying the Imputed Underpayment

Under the New Rules, a partnership's Imputed Underpayment is calculated by multiplying the IRS net positive audit adjustment to the partnership's taxable income by the highest marginal federal income tax rate (individual or corporate, as applicable) in effect for the tax year subject to audit (the Reviewed Year). The partnership, however, can request modifications of the Imputed Underpayment computed by the IRS, including by demonstrating that (i) Reviewed Year partners have amended their tax returns for the Reviewed Year to reflect their share of the adjustments and have paid the related increase in tax, (ii) a portion of the adjustments are properly allocable to a partner not subject to federal income tax (for example, a tax-exempt entity), or (iii) a portion of the adjustments are allocable to a corporate partner or properly treated as capital gain or qualified dividends allocable to an individual partner, in each case, subject to a lower federal income tax rate. Tax-exempt and corporate fund investors may request that, if they assist the fund in utilizing their tax status to reduce the fund's Imputed Underpayment, the fund will allocate a reduced amount of the Imputed Underpayment to that partner to account for the benefit of the modification related to such partner's status.

Because the Imputed Underpayment, as adjusted for any modification approved by the IRS, is assessed on the partnership, the partners in the year in which the audit concludes and the assessment is made (the Adjustment Year) must bear the economic burden of the underpayment rather than the Reviewed Year partners. Such result may be inequitable if the ownership interests of one or more partners in the partnership in the Reviewed Year differ from their interests in the partnership in the Adjustment Year. This result is particularly likely in private funds, where limited partner interests are frequently acquired, redeemed and sold.

The Push-Out Election under the New Rules

This potential inequity, along with the administrative burden of seeking modifications from the IRS, can be avoided with a ***special election*** under the New Rules (the Push-Out Election). The Push-out Election permits the partnership to allocate the IRS adjustments to the Reviewed Year partners, which will bear the related increase in tax. To effect the Push-out Election, the partnership must send a statement to each Reviewed Year partner showing its share of the partnership's audit adjustments, and each Reviewed Year partner then is required to include its share of the audit adjustments on its current year tax return and pay any resulting increase in tax. The Push-out Election can be used to push audit adjustments through multiple tiers of partnerships, which is particularly important in complex private fund structures with multiple levels of ownership by partnerships. If a Push-Out Election is made, however, an additional interest charge of 200 basis points will apply to the underpayment amount. That is, the underpayment rate is increased from the applicable federal rate, plus 3 percent, to the applicable federal rate, plus 5 percent.

The Push-out Election should be advantageous to private funds in most situations. Funds, however, should be wary of adopting a "one size fits all" approach to the election and therefore should not bind themselves to making the Push-out Election in all instances in their fund documents. For example, in the case of an immaterial underpayment, the administrative burden of circulating and filing the required statements could outweigh any benefit of the election. Even if the underpayment is material, some general partners of funds with complex structures may resist the administrative burden associated with distributing push-out statements through multiple tiers of partnerships. Finally, pursuant to recent guidance, partnerships can achieve a similar result as under the Push-out Election under a new procedure [1] (the Pull-in Procedure), which permits direct and indirect Reviewed Year partners to submit an information statement relating to the audit adjustments and pay any tax owed, but without the additional 200 basis point charge.

The Election to Opt Out of the New Rules

A partnership can ***elect*** to be excluded from the application of the New Rules (the Election Out) if it has 100 or fewer eligible partners, and no ineligible partners. Pursuant to final regulations recently issued by the Treasury Department, individuals, C-corporations and S-corporations are eligible partners for this purpose, but partnerships and disregarded entities are ineligible partners. As a result, any partnership with even a single partner that is a disregarded entity or partnership will be unable to make the Election Out and, as a result, the vast majority of private funds will be unable to make this election and will remain subject to the New Rules. If a partnership makes the Election Out, any federal income tax examination or audit of the partnership is conducted at the partner level, on a partner-by-partner basis, under the audit procedures otherwise applicable to each partner.

The Role of the Partnership Representative under the New Rules

The New Rules replace the designation of a tax matters partner under the TEFRA rules with the designation of a ***partnership representative***, which can be an entity or individual with substantial US presence, but does not need to be a partner in the partnership. The partnership representative has the sole authority to act on behalf of the partnership, and legally bind the partnership, with respect to federal income tax examinations and audits. No contractual arrangement, including any partnership agreement or state law document, can limit or alter this authority. In addition, other than the partnership representative, no partner or other person may participate in any federal income tax examination or audit.

Typically, a private fund's general partner will be designated to serve as the partnership representative. Funds generally view the general partner's authority over federal income tax examinations and audits as consistent with its broader governance role over the fund. However, limited partners may be motivated to negotiate for notice rights, and consultation or consent rights, with respect to audit activity to guide the partnership representative's action with the IRS. For example, limited partners may request notice of the initiation of a partnership examination or audit and the right to be kept reasonably informed with respect to these matters by the partnership representative, because these rights are not guaranteed under the New Rules. In addition, limited partners may seek the right to consult with the partnership representative on key decisions, determinations and elections related to an examination or audit, and may even ask for a prohibition on certain actions by the partnership representative without such limited partners' consent. Examples of such key decisions are whether the partnership should make the Push-out Election or apply the Pull-in Procedure, and how the partnership should allocate the Imputed Underpayment among Adjustment Year partners. However, a general partner serving as partnership representative should be cautious with respect to broad consent rights. Such consent rights could cause a deadlock among partners, which could delay the orderly administration of a partnership audit or even cause the partnership representative to miss a deadline imposed by the New Rules or the IRS. An alternative approach is to put these key decisions, determinations and elections in the hands of the general partner's board or the partners of the general partner, although this may not necessarily eliminate the risk of deadlock or delay.

Planning Ahead under the New Rules

Going forward, new partnership agreements and LLC operating agreements in fund structures should be drafted to reflect the New Rules, including designating the partnership representative and describing the limited partners' ability, if any, to be consulted on or object to the partnership representative's actions. These agreements also should include rules and procedures for allocating an Imputed Underpayment among the Adjustment Year partners, and should provide an obligation for Adjustment Year partners to indemnify the partnership for their share of an Imputed Underpayment, regardless of whether or not they have left the partnership. Finally, offering documents for private funds should add disclosure regarding the New Rules and their potential impact on investors. The market has settled on relatively brief, high-level disclosure relating to these rules, but funds should be cognizant that disclosure must be revised as and when new material guidance under the New Rules is issued.

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[1] To view our post about the Pull In Procedure, click ***here***.